

**LEGISLATIVE SERVICES AGENCY
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FISCAL IMPACT STATEMENT

LS 6287

BILL NUMBER: SB 388

NOTE PREPARED: Dec 28, 2010

BILL AMENDED:

SUBJECT: Local Government Investment in Swap Agreements.

FIRST AUTHOR: Sen. Waltz

FIRST SPONSOR:

BILL STATUS: As Introduced

FUNDS AFFECTED: X GENERAL
X DEDICATED
FEDERAL

IMPACT: Local

Summary of Legislation: The bill limits the ability of a local unit of government to invest in swap agreements by providing that the market value of all rights accruing to the local unit under all swap agreements it has entered into may not exceed 10% of the local unit's total portfolio of investments.

Effective Date: July 1, 2011.

Explanation of State Expenditures:

Explanation of State Revenues:

Explanation of Local Expenditures: The bill would limit the ability of a local unit to utilize a swap agreement to change the local unit's interest rate and interest cash flows relating to a particular debt issue or obligation. The bill prohibits a local unit from entering into a swap agreement with respect to a debt issue after June 30, 2011, if the swap agreement would cause the market value of all rights accruing to the local unit under all of its swap agreements to exceed 10% of the market value of the local unit's total investment portfolio.

The extent to which the interest cost of local units might be affected by the limit specified in the bill is unknown. Comprehensive information about local units' usage of swap agreements is unavailable. The impact would depend on the swap agreements entered into by local units, the extent to which local units obtained favorable interest rates from these agreements, and the expertise of local units in managing derivative instruments like swap agreements.

Background Information - A swap agreement is a contract between a *payer* that is issuing some type of debt issue, like a local unit issuing bonds, and a *receiver*, like an investment bank. Generally, the payer is trying to exchange a floating interest rate on the principal of a debt issue for a fixed interest rate. A swap agreement does not change the principal amount of the debt issue or result in the exchange of the principal amount. It only allows the payer to make fixed rate interest payments to the receiver in exchange for the receiver making floating rate interest payments to the payer, with the interest payments being based on the principal amount of the debt issue. Under a swap agreement, the floating interest rate would be based on some reference rate like the Prime rate or the LIBOR. The interest payments from each party would be due periodically (i.e. quarterly), at which time the floating interest rate would reset to equal the prevailing rate. There are three outcomes that can occur relative to the periodic interest payments:

- (1) If the floating rate is greater than the fixed rate at the time of payment, the investment bank pays the local unit an amount equal to the difference between the interest payment at the higher floating rate and the interest payment at the fixed rate.
- (2) If the floating rate is less than the fixed rate at the time of payment, the local unit pays the investment bank an amount equal to the difference between the interest payment at the higher fixed rate and the interest payment at the floating rate.
- (3) If the floating rate equals the fixed rate at the time of payment, payment is exchanged between the investment bank and the local unit.

The main advantage for a local unit to exchange a floating rate for a fixed rate under a swap agreement is to avoid higher interest payments under the floating rate, if interest rates are expected to increase above the fixed rate that is obtained via the swap agreement. The main disadvantage for a local unit to exchange a floating rate for a fixed rate is that once in the swap agreement the local unit can't take advantage of interest rates falling below the fixed rate of the swap agreement without terminating the swap agreement and paying a substantial termination fee.

Explanation of Local Revenues:

State Agencies Affected:

Local Agencies Affected: Local units.

Information Sources:

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